

Report
of the
Examination of
All-Star Mutual Insurance Company
Stoughton, Wisconsin
As of December 31, 2003

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State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

Jim Doyle, Governor
Jorge Gomez, Commissioner

Wisconsin.gov

May 14, 2004

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Honorable Jorge Gomez
Commissioner of Insurance
State of Wisconsin
125 South Webster Street
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Commissioner:

In accordance with your instructions, an examination has been performed as of
December 31, 2003, of the affairs and financial condition of:

ALL-STAR MUTUAL INSURANCE COMPANY
Stoughton, Wisconsin

and the following report thereon is respectfully submitted:

I. INTRODUCTION

The previous examination of All-Star Mutual Insurance Company (the company) was made in 2000 as of December 31, 1999. The current examination covered the intervening time period ending December 31, 2003, and included a review of such subsequent transactions deemed essential to complete this examination.

The "Summary of Examination Results" contains elaboration on all areas of the company's operations. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The company was originally organized as a town mutual insurance company on February 5, 1882, under the provisions of the then existing Wisconsin Statutes. The original name of the company was the Mazomanie & Black Earth Mutual Farmers Fire & Lightning Insurance Company. Subsequent amendments to the company's articles and bylaws changed the company's name to Mazomanie Mutual Insurance Company.

Mazomanie Mutual Insurance Company merged with Blue Mounds Mutual Insurance Company on January 1, 1979. As a result of the merger the company amended its articles and bylaws including changing the company's name to Mazomanie-Blue Mounds Mutual Insurance Company.

Effective January 1, 1996, Mazomanie-Blue Mounds Mutual Insurance Company merged with Albion Mutual Insurance Company. The merged companies were renamed to All-Star Mutual Insurance Company. Several amendments to the articles and bylaws were associated with the merger.

The company is currently licensed to write property, including windstorm and hail, and nonproperty insurance. The company is currently licensed to write business in the following counties:

Adams	Juneau
Columbia	Lafayette
Crawford	Richland
Dane	Rock
Grant	Sauk
Green	Vernon
Iowa	Walworth
Jefferson	

A review was made of the policy and application forms currently used by the company. The company issues an approved policy with or without endorsements for terms of one year with premiums payable on the advance premium basis. Policyholders are provided the option to pay premium on an installment basis (e.g., monthly, quarterly, etc.). For this convenience, the company charges a fee of \$2 for each monthly installment and \$5 for each quarterly or semi-annual payment received. In addition, the company charges a \$10 fee upon each renewal. These fees are retained by the company and not ceded to its reinsurer.

The company has 90 agents appointed to write business for the company, 2 of whom are directors of the company. The large number of agents is due to the company having agreements at the agency level covering all agents within the agency. Approximately 80% of the business is written by 22 agents who include the 2 directors previously noted. Commissions are 14% on new and renewal premiums. In addition, agencies are entitled to receive a contingent commission. To be eligible for the contingent commission bonus, an agency must have at least

\$20,000 in net written premium during the accounting period. The agency agreement must have been in effect one full year at the end of the accounting period and the agency account must not be delinquent at year-end. The contingent commission is 0-3% based on the loss ratio of the business written.

The manager adjusts the majority of losses for the company as a part of his responsibilities and also receives \$0.375 per mile plus a \$300 per month mileage bonus. Claims adjusting can also be performed by a company-appointed agency, or an agent who has prior approval from the manager. Agents do not receive reimbursement for adjusting losses. Independent adjusters are used occasionally for difficult claims. Further information concerning claims adjusting procedures can be found in the "Claims Adjusting" section of this report.

Policyholders may participate in the management and control of the company by attending and voting at all annual or special meetings of the members. A record of attendance is not kept for annual meetings. No member may vote by proxy. The annual meetings of the company for the election of directors and special meetings of the company are held in accordance with its articles of incorporation.

Board of Directors

The board of directors consists of nine members divided into three classes. One class is elected at each annual meeting for a term of three years. Vacancies on the board may be filled by the remaining directors until the next annual meeting when a director shall be chosen for the unexpired term.

The current board of directors consists of the following policyholders of the company:

Name	Principal Occupation	Residence	Expiry
John Horton*	Insurance Agent and Adjuster	Janesville, WI	2007
Paul Schultz	E-Commerce/Web Specialist	Edgerton, WI	2007
Genevieve Wilberg	Retired School Teacher	Stoughton, WI	2007
Pat Farrell	Self-Employed Carpenter and Lawn Care/Snow Removal	Mt. Horeb, WI	2006
Tom Augustine	Farmer	Edgerton, WI	2006
Henry Steinhauer	Farmer	Mt. Horeb, WI	2006
Gary Hefty	Supervisor at Walgreens Distribution Center	Waunakee, WI	2005
Irma Radermacher*	Insurance Agent	Edgerton, WI	2005
Edwin Nelson	Retired Self-Employed in Construction	Stoughton, WI	2005

Directors who are also agents are identified with an asterisk.

Members of the board currently receive \$50 for half-day meetings and \$80 for full-day meetings attended and \$0.375 per mile for travel expenses.

Officers

Officers are elected by the board of directors from among its members and hold office for one year or until their successors are duly elected and qualified. The officers and manager serving at the present time are as follows:

Name	Office	2003 Salary
Gary Hefty	President	\$ 2,400
Irma Radermacher	Vice President	1,000
Pat Farrell	Secretary/Treasurer	1,500
Steve Krattiger	Manager	43,000

Committees of the Board

The company's bylaws allow for the formation of certain committees by the board of directors. The committees at the time of the examination are listed below:

Adjusting Committee

Tom Augustine, Chair
John Horton
Gary Hefty

Investment Committee

Henry Steinhauer, Chair
Irma Radermacher
Pat Farrell

Personnel Committee

Paul Schultz, Chair
Genevieve Wilberg
Tom Augustine

Rate Committee

Irma Radermacher, Chair
John Horton
Edwin Nelson

Growth of Company

The growth of the company since the previous examination as compiled from its filed annual statements was as follows:

Year	Net Premiums Earned	Policies In Force	Net Income	Admitted Assets	Policyholders' Surplus
2003	\$904,835	2,237	\$123,011	\$1,975,281	\$761,418
2002	785,845	2,140	16,367	1,721,234	633,997
2001	741,688	2,236	(55,219)	1,612,434	626,151
2000	810,994	2,392	(94,698)	1,645,094	685,245
1999	879,259	2,531	206,788	1,763,391	776,229

The ratios of gross and net premiums written to surplus as regards policyholders since the previous examination were as follows:

Year	Gross Premiums Written	Net Premiums Written	Ending Surplus	Writings Net	Ratios Gross
2003	\$1,615,585	\$1,009,816	\$761,418	133%	212%
2002	1,420,742	828,330	633,997	131	224
2001	1,424,230	809,419	626,151	129	227
2000	1,412,447	773,829	685,245	113	206
1999	1,554,371	883,108	776,229	114	200

For the same period, the company's operating ratios were as follows:

Year	Net Losses and LAE Incurred	Other Underwriting Expenses Incurred	Net Earned Premiums	Loss Ratio	Expense Ratio	Composite Ratio
2003	\$405,305	\$420,443	\$904,835	45%	42%	86%
2002	484,661	363,043	785,845	62	44	106
2001	565,934	340,723	741,688	76	42	118
2000	741,682	344,946	810,994	91	45	136
1999	393,889	380,104	879,259	45	43	88

The company's surplus has remained relatively unchanged over the past four years. However, operating results have fluctuated significantly as the company reported underwriting losses in three of the last four years. Losses in 2002 were a result of several significant fires whereas 2000 and 2001 were due to heavy storms and associated loss adjusting expenses. Despite underwriting losses in 2000 – 2002, the company was able to post net income in two of the last four years.

The premium volume relative to surplus is above average for a town mutual insurer and has been for several years. Since the prior examination, both gross and net premiums written have increased by 4% and 14%, respectively, while surplus has decreased slightly. During the same period, however, policies in force decreased by 12%. The decline in the company's policies in force was due in large part to the former manager transferring the block of business he controlled to other insurance companies upon renewal. Rate increases have offset losses in policy count and have contributed to the increases in written premium noted above.

II. REINSURANCE

The examiners' review of the company's reinsurance portfolio revealed there is currently one ceding treaty. The treaty contained a proper insolvency clause and complied with s. Ins 13.09 (3), Wis. Adm. Code, concerning maximum wind loss. Maximum risk retentions complied with s. Ins 13.06, Wis. Adm. Code.

Reinsurer:	Grinnell Mutual Reinsurance Company
Effective date:	January 1, 2004
Termination provisions:	December 31, 2004, or any subsequent December 31, by either party providing at least 90 days' advance written notice

The coverages provided under this treaty are summarized as follows:

1. Individual occurrence of loss: Excess of loss – property insurance

Lines reinsured:	Property
Company's retention:	\$100,000
Coverage:	100% of an individual occurrence loss above the company's retention. The maximum coverage for livestock, commercial and public property, and dwellings is \$500,000 per occurrence. The maximum coverage for farm outbuildings is \$750,000 per occurrence.
Reinsurance premium:	\$0.0166 per \$1,000 of Adjusted Gross Fire Risk in Force at the end of each month during the contract year
2. Aggregate excess reinsurance sections:

Lines reinsured:	Property
Company's retention:	Annual net losses limited to the defined retention limit of \$821,668, however, in no event shall the liability of the reinsured exceed the amount allowed by s. Ins 13.09, Wis. Adm. Code
Coverage:	100% of amounts exceeding the annual retention limit
Reinsurance premium:	\$0.04 per \$1,000 of Adjusted Gross Fire Risk in Force at the end of each month during the contract year
3. Facultative reinsurance section:

Lines reinsured and coverage provided:	These terms are determined on a per-risk basis with limits set forth in the contract
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4. Liability section:

Lines reinsured:	Personal Liability
Company's retention:	None
Coverage:	100%
Reinsurance premium:	100% Premiums charged
Ceding commission:	20% of ceded premium
Contingent commission:	5-30% considering net premiums written and net underwriting profits realized by the reinsurer

III. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported to the Commissioner of Insurance in the December 31, 2003, annual statement.

Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Policyholders' Surplus."

All-Star Mutual Insurance Company
Statement of Assets and Liabilities
As of December 31, 2003

Assets	Ledger	Nonledger	Not Admitted	Net Admitted
Cash in company's office	\$ 50	\$	\$	\$ 50
Cash deposited in checking account	82,794			82,794
Cash deposited at interest	491,870			491,870
Bonds	863,869			863,869
Stocks and mutual fund investments	128,206			128,206
Premiums, agents' balances and installments:				
In course of collection	190,245		3,903	186,342
Deferred and not yet due	192,910			192,910
Investment income accrued		20,672		20,672
Electronic data processing equipment	3,468			3,468
Other expense-related assets:				
Reinsurance contingent commission receivable	5,100			5,100
Other nonexpense-related assets:				
Furniture and fixtures	2,387		2,387	0
Other nonadmitted assets:				
Co-op Stock	<u>75</u>	<u> </u>	<u>75</u>	<u>0</u>
Totals	<u>\$1,960,974</u>	<u>\$20,672</u>	<u>\$6,365</u>	<u>\$1,975,281</u>

All-Star Mutual Insurance Company
Statement of Assets and Liabilities (cont.)
As of December 31, 2003

Liabilities and Surplus

Net unpaid losses	\$ 140,000
Unpaid loss adjustment expenses	1,744
Commissions payable	57,976
Fire department dues payable	1,095
Federal income taxes payable	44,000
Unearned premiums	818,013
Reinsurance payable	76,315
Amounts withheld for the account of others	3,761
Other liabilities:	
Expense related:	
Accounts payable	7,000
Accrued Salaries and Wages	1,300
Nonexpense related:	
Premiums received in advance	62,659
Total Liabilities	<u>1,213,863</u>
Policyholders' surplus	<u>761,418</u>
Total Liabilities and Surplus	<u>\$1,975,281</u>

All-Star Mutual Insurance Company
Statement of Operations
For the Year 2003

Net premiums and assessments earned		\$904,835
Deduct:		
Net losses incurred	\$358,511	
Net loss adjustment expenses incurred	46,794	
Other underwriting expenses incurred	<u>420,443</u>	
Total losses and expenses incurred		<u>825,748</u>
Net underwriting gain (loss)		79,087
Net investment income:		
Net investment income earned	54,375	
Net realized capital gains	<u>4,541</u>	
Total investment gain (loss)		58,916
Other income:		
Miscellaneous Income		<u>35,008</u>
Net income (loss) before federal income taxes		173,011
Federal income taxes incurred		<u>50,000</u>
Net Income (Loss)		<u>\$123,011</u>

All-Star Mutual Insurance Company
Reconciliation and Analysis of Surplus as Regards Policyholders
For the 5-Year Period Ending December 31, 2003

The following schedule is a reconciliation of surplus as regards policyholders during the period under examination as reported by the company in its filed annual statements:

	2003	2002	2001	2000	1999
Surplus, beginning of year	\$633,997	\$626,148	\$685,245	\$776,229	\$571,410
Net income	123,011	16,367	(55,222)	(94,698)	206,788
Net unrealized capital gains or (losses)	5,870	(7,522)	(4,114)	6,827	(3,761)
Change in non-admitted assets	<u>(1,460)</u>	<u>(996)</u>	<u>239</u>	<u>(3,113)</u>	<u>1,792</u>
Surplus, end of year	<u>\$761,418</u>	<u>\$633,997</u>	<u>\$626,148</u>	<u>\$685,245</u>	<u>\$776,229</u>

Reconciliation of Policyholders' Surplus

The examination resulted in no reclassifications or adjustments to policyholders' surplus. However, adjustments would have been made to each of the following accounts if the amount of the adjustment could have been quantified in a timely manner: premiums, agents' balances in course of collection, premiums deferred and not yet due, reinsurance contingent commission receivable, commissions payable, unearned premiums, reinsurance payable, and premiums received in advance. The issues with the accounts listed are discussed later in the report under the section titled, "Current Examination Results."

IV. SUMMARY OF EXAMINATION RESULTS

Compliance with Prior Examination Report Recommendations

Comments and recommendations contained in the last examination report and the action taken on them by the company are as follows:

1. Underwriting—It is recommended that the company perform a detailed loss analysis.
Action—Compliance
2. Claims Adjusting—It is recommended that the company appoint an adjusting committee, pursuant to s. 612.13 (4), Wis. Stat.
Action—Compliance
3. Accounts and Records—It is recommended that the company properly “void” checks, which are not immediately used, pursuant to s. Ins 13.05 (4), Wis. Adm. Code.
Action—Compliance
4. Accounts and Records—It is recommended that the company establish and comply with a reasonable threshold at which duplicate signatures would be required for disbursements, pursuant to s. Ins 13.05 (4), Wis. Adm. Code.
Action—Compliance
5. Accounts and Records—It is recommended that the company develop and submit to this office, within 90 days after the adoption of this report, formalized cash handling procedures to ensure the proper segregation of duties.
Action—Compliance
6. EDP Equipment—It is recommended that the company establish procedures to limit access to its computers.
Action—Compliance
7. Disaster Recovery Plan—It is recommended that the company develop a formal disaster recovery plan.
Action—Compliance
8. Invested Assets—It is recommended that the company comply with s. 610.23, Wis. Stat., and s. Ins 13.05, Wis. Adm. Code, as regards custody and control of its invested assets.
Action—Compliance
9. Invested Assets—Given the investment compliance issues noted throughout this report, it is recommended that the company maintain prospectuses and rating information for its current investments.
Action—Compliance

10. Transition into the New Investment Rule—It is recommended that the company develop a formal investment plan in compliance with s. Ins 6.20 (6) (h), Wis. Adm. Code.

Action—Compliance

11. Stocks and Mutual Funds—It is recommended that the company divest its common stock and stock mutual funds that are not in compliance with the new investment rule.

Action—Compliance

12. Book Value of Real Estate—It is recommended that the company continue to pursue an amendment to its articles to accurately reflect its change in location.

Action—Compliance

13. Net Unpaid Losses—It is again recommended that the company list and assign claim numbers to all nonproperty claims in its loss claim register pursuant to s. Ins 13.05 (3) (f), Wis. Adm. Code.

Action—Compliance

14. Net Unpaid Losses—It is recommended that the company obtain signed proofs of loss from all claimants or establish and comply with a threshold for which signed proofs of loss will be required.

Action—Compliance

15. Net Unpaid Losses—It is recommended that the company comply with s. Ins 13.05 (4) (e), Wis. Adm. Code, and assign claim numbers to claims at the time they are first reported to the company.

Action—Compliance

16. Net Unpaid Losses—It is recommended that the company include sufficient documentation in its claim files in order to ensure compliance with the applicable regulations.

Action—Compliance

17. Amounts Withheld for the Account of Others—It is again recommended that the company report amounts withheld for the account of others in accordance with Wisconsin Town Mutual Annual Statement Instructions.

Action—Compliance

Current Examination Results

Corporate Records

The minutes of the annual meetings of policyholders and meetings of the board of directors and committees thereof were reviewed for the period under examination and also for the subsequent period. The number of policyholders attending the annual meetings under review was not listed in the minutes of the policyholders. It is recommended that the company document the number of policyholders present at each annual meeting so that it may be determined that a quorum was present and that the company is in compliance with s. 181.0722, Wis. Stat.

The minutes also disclosed instances where directors who were agents did not abstain from voting on items that directly affected them (e.g., commissions). In addition, directors who were also officers did not abstain from the vote on their salaries. It is appropriate for directors to contribute to board discussions even in those instances in which they have a conflict of interest, but when directors have a potential conflict of interest they should refrain from voting on applicable resolutions and the abstention should be indicated in the minutes. It is recommended that directors with a potential conflict of interest properly abstain from voting on matters affecting their interest and that the minutes clearly indicate their abstention, pursuant to ss. 612.18 and 611.60 (2), Wis. Stat.

According to s. Ins 6.20 (6), Wis. Adm. Code, "investments acquired and held under this section shall be acquired and held under the supervision and direction of the board of directors." However, the review of the minutes did not indicate authorizations for the purchases and sales of investments. It is recommended that all investment purchases and sales be discussed during meetings of the board of directors and that the minutes indicate that such discussions have taken place and whether the transactions were approved or disapproved.

Biographical data relating to company officers and directors have been reported in accordance with the provisions of s. Ins 6.52, Wis. Adm. Code.

The company has executed formal written agreements with its agencies. The contracts include language indicating the agency will represent the company's interests "in good faith." As part of the agency agreement, the agencies are required to obtain adequate errors and

omissions (E&O) coverage. The agents are to submit proof of this coverage to the company as part of the agency agreement. The company has not maintained a record nor enforces this requirement of the agencies. It is recommended the company obtain and retain a copy of all their agencies current E&O coverage to provide assurance that the agencies have adequate coverage.

Conflict of Interest

In accordance with a directive of the Commissioner of Insurance, each company is required to establish a procedure for the disclosure to its board of directors of any material interest or affiliation on the part of its officers, directors, or key employees which conflicts or is likely to conflict with the official duties of such person. A part of this procedure is the annual completion of a conflict of interest questionnaire by the appropriate persons. The company has adopted such a procedure for disclosing potential conflicts of interest.

In reviewing potential conflicts of interest it was revealed that a director, who also is an agent for the company, has been appointed by several other property and casualty insurers considered competitors of the company. This conflict of interest was not reported on the questionnaire. It is recommended that the board of directors clarify their conflict of interest statement to better define circumstances that would be considered conflicts. It is further recommended that the directors note all potential conflicts of interest on their statements, per directive of the Commissioner of Insurance.

Business Plan

The company did not have a comprehensive business plan to address how it will achieve its goals and specifically address the issues of operational results, premium leverage, property inspections, and insuring to value. A business plan should integrate the board and management's vision of the company's goals and how they will be achieved. The company should also prepare a budget, as part of the business plan, to gain a better awareness of its operating results through monitoring the variances in the budgeted amounts and the actual results. It is recommended that the company submit a comprehensive business plan to the Commissioner of Insurance within 90 days of the adoption of this report. It is further recommended that the company review and update the plan on an annual basis.

Fidelity Bond and Other Insurance

The company is afforded coverage under the terms of the following bonds or contracts and has complied with s. Ins 13.05 (6), Wis. Adm. Code, which sets forth the minimum requirements for fidelity bond coverage:

Type of Coverage	Coverage Limits
Fidelity bond, \$5,000 deductible	\$ 500,000
Professional liability each claim/aggregate limit, \$25,000 deductible	1,000,000
Directors and officers liability each claim/aggregate limit, \$25,000 deductible	1,000,000
Workers Compensation:	
Employee injury	Statutory
Employee liability:	
Each accident	100,000
Each employee	100,000
Policy limit	500,000
Business liability insurance	
Business liability coverage	1,000,000
Per person medical expenses	5,000
Fire legal liability per fire or explosion	50,000

Underwriting

The company has a written underwriting guide. The guide covers all the lines of business that the company is presently writing.

The company has a formal inspection procedure for both new and renewal business. The company inspects nearly all new business; some exceptions are made for minimal risks. Since the spring of 2003, the company has initiated reinspections of renewal business attempting to have all business inspected at least every 5 years. Currently out of approximately 2,400 policies the company has performed 500 reinspections and has issued approximately 1,000 new policies over the last 3 years leaving about 1,000 reinspections to be performed. The manager expressed concerns with property being insured to value. Given the importance of proper underwriting and, specifically, insurance to value, it is suggested the company continue to re-inspect property to ensure that all business is insured to value.

Facultative reinsurance is available from the company's reinsurer to provide coverage on individual risks that exceed the per risk limits applicable to the individual excess of loss treaty.

What constitutes an individual risk involves the evaluation of individual building values and the proximity of other covered structures. The company does not have formal procedures approved by the board to determine whether facultative reinsurance is necessary. The manager stated that it is the company's intention to make sure that facultative reinsurance is placed on any policy that may exceed the maximum coverage. However, when the examiners reviewed the 10 largest policies it was found that three properties with total risks of \$2.9 million, \$2.4 million and \$1.6 million were not evaluated as to whether facultative reinsurance should be acquired. In order to reasonably ensure that facultative coverage is obtained when necessary, it is recommended that the company either: 1) report all policies that may exceed the maximum per risk coverage to its reinsurer and allow the reinsurer to inspect the property and evaluate whether facultative reinsurance is necessary or 2) develop and consistently apply its own procedures to evaluate risks.

Claims Adjusting

The company has an adjusting committee consisting of at least three directors as required by s. 612.13 (4), Wis. Stat. The review noted no Adjusting Committee meetings. Currently, the full board meets to discuss or review claims in which there are difficulties in settlement. The typical function of this committee is to adjust or supervise the adjustment of all losses. It is recommended that the adjusting committee establish formal guidelines to adjust or review all losses over a certain dollar limit, meet regularly to review adjusting decisions, keep minutes of such meetings, and report regularly to the full board.

The company lacks a formal policy that claims in excess of a specified amount be approved by more than one individual. It is recommended that the company establish an amount above which claims shall be approved by more than one employee of the company, officer, director, or agent pursuant to s. Ins 13.05 (4) (e), Wis. Adm. Code.

Accounts and Records

The examiners' review of the company's records indicated that the company is in compliance with s. Ins 13.05, Wis. Adm. Code, which sets forth the minimum standards for the

handling of cash and recording of cash transactions by town mutual insurance companies. The examiners noted the following:

1. A proper policy register is maintained
2. A proper cash receipts journal is maintained
3. A proper cash disbursements journal is maintained
4. A proper general journal is maintained
5. A proper general ledger is maintained

An extensive review was made of income and disbursement items. Cash receipts were traced from source records and the proper recording and eventual deposit thereof ascertained. Negotiated checks issued during the period under examination were reviewed, test checked for proper endorsement, and traced to cash records. The verification of assets and determination of liabilities were made as of December 31, 2003.

The company is audited annually by an outside public accounting firm.

EDP Environment

Company personnel were interviewed with respect to the company's electronic data processing environment. Access to the computers is limited to people authorized to use the computers. Company personnel back up the computers daily and the backed-up data is kept off-site. A manual which describes how to use the company's software and outlines the steps to complete specific tasks assists in the continuity of operations for seldom-used applications, training, or when staff turnover occurs. The company has manuals documenting the use of its software.

Business Continuity Plan

A business continuity plan identifies steps to be performed by a company in the event of business interruptions including, but not limited to, the inability to access its computer, the loss of information on its computer, the loss of a key employee, or the destruction of its office building. The company has developed a business continuity plan. The company's business continuity plan appears to be adequate.

Invested Assets

Section 610.23, Wis. Stat., requires insurers to hold all investments and deposits of its funds in its own name except that:

- (1) Securities kept under a custodial agreement or trust arrangement with a bank or banking and trust company may be issued in the name of a nominee of the bank or banking and trust company; and
- (2) Any insurer may acquire and hold securities in bearer form.

For securities not held under a custodial agreement or trust arrangement with a bank or banking and trust company, s. Ins 13.05 (4), Wis. Adm. Code, requires that:

Non-negotiable evidences of company investments such as registered bonds, certificates of deposits, notes, etc., shall be maintained in a safe or vault with adequate safety controls or in a safety deposit box in a bank. Negotiable evidences of company investments shall be maintained in a safety deposit box in a bank. Access to a company safety deposit box containing negotiable securities shall require the presence and signature of at least 2 officers, directors or employees of the company.

The company is in compliance with these requirements.

Investment Rule Compliance

The investment rule for town mutual insurers allows a company to invest in common stocks, common stock mutual funds, and other higher risk investments (referred to as "Type 2") provided that the town mutual has a sufficient amount of lower risk investments (referred to as "Type 1"). A town mutual may invest in Type 2 securities only if it already has sufficient Type 1 investments. Type 1 investments must equal or exceed the greater of items 1, 2, or 3.

1. Liabilities plus \$300,000	\$1,513,863
2. Liabilities plus 33% of gross premiums written	1,747,006
3. Liabilities plus 50% of net premiums written	1,718,771
4. Amount required (greater of 1, 2, or 3)	1,747,006
5. Amount of Type 1 investments as of 12/31/2003	<u>1,486,037</u>
6. Excess or (deficiency)	<u>\$ (260,969)</u>

The company does not have sufficient Type 1 investments.

It was noted during examination of securities that two bonds, and one preferred stock, were incorrectly reported as Type 1 investments. These investments are considered Type 2 due to being rated less than "BBB" by an authorized rating organization. The review also noted the company did not properly calculate bonds with less than "BBB" ratings on Page 13 of the annual statement. All bonds with less than "BBB" ratings are to be reported on Page 13 of the Town

Mutual Annual Statement for the calculation of unrealized gains (losses). The statement values of these bonds are to be carried at the lesser of cost or market value pursuant to the Town Mutual Annual Statement Instructions. In addition, unrealized capital gains (losses) are calculated as the difference between statement value and book value (amortized value). The difference in the reported value was not material to the audited value and no adjustment was considered necessary. It is recommended company report the correct type designation for all securities pursuant to the Town Mutual Annual Statement Instructions.

ASSETS

Cash and Invested Cash

\$574,714

The above asset is comprised of the following types of cash items:

Cash in company's office	\$ 50
Cash deposited in banks-checking accounts	82,794
Cash deposited in banks at interest	<u>491,870</u>
Total	<u>\$574,714</u>

Cash in the company's office at year-end represents the company's petty cash fund.

A physical count was made by the examiners during the course of the examination and the balance reconciled to year-end.

Cash deposited in banks subject to the company's check and withdrawal consists of one account maintained in a local bank. Verification of checking account balances was made by obtaining confirmations directly from the depository and reconciling the amounts shown thereon to company records.

Cash deposited in banks represents the aggregate of 17 deposits in nine depositories. Deposits were verified by direct correspondence with the respective depositories and by an actual count and inspection of certificates and/or passbooks. Interest received during the year 2003 totaled \$12,949 and was verified to company cash records. Rates of interest earned on cash deposits ranged from 0.9% to 5.0%. Accrued interest on cash deposits totaled \$5,252 at year-end.

Book Value of Bonds

\$863,869

The above asset consists of the aggregate book value of bonds held by the company as of December 31, 2003. Bonds owned by the company are held in a banking and trust company under a custodial agreement.

Verification of the book value of bonds was made by obtaining a confirmation directly from the custodian and reconciling the amounts shown thereon to company records. Bond purchases and sales for the period under examination were checked to brokers' invoices and advices. The company's investment in bonds was in conformance with Wisconsin Statutes and

the rules of the Commissioner of Insurance as regards investments made by town mutual insurers.

Interest received during 2003 on bonds amounted to \$47,914 and was traced to cash receipts records. Accrued interest of \$15,420 at December 31, 2003, was checked and allowed as a nonledger asset.

Stocks and Mutual Fund Investments

\$128,206

The above asset consists of the aggregate market value of stocks and money market funds held by the company as of December 31, 2003. Stocks owned by the company are located in a fire proof safe at the company or are held in a banking and trust company under a custodial agreement.

Stock certificates in the fireproof safe were physically examined by the examiners. Stocks and money market funds were verified by obtaining a confirmation directly from the custodian and reconciling the amounts shown thereon to company records. Stock and money market fund purchases and sales for the period under examination were checked to brokers' invoices and advices. The company's investment in stocks and mutual funds was in conformance with Wisconsin Statutes and the rules of the Commissioner of Insurance as regards investments made by town mutual insurers.

Dividends received during 2003 on stocks and money market funds amounted to \$5,110 and were traced to cash receipts records.

Premiums, Agents' Balances in Course of Collection

\$186,342

This asset is intended to represent the amounts due from agents or policyholders which are not in excess of 90 days past due at year-end. In determining this balance, the company used a report generated from its software system titled "Accounts Receivable Aging Report." The company provided a printed copy of this report, but could not produce an electronic version of the report. This report included the combination of the following amounts: 1) amounts due from agents or policyholders, 2) premium billed for policies with effective dates in 2004 and 3) deferred installments due in 2004 for policies with 2003 effective dates. Amounts due from agents or policyholders and deferred installments are admitted assets under statutory accounting.

However, premium billed for policies with effective dates in 2004 is not a statutory asset and should not have been included in any annual statement balance. In addition, installments due in 2004 for policies with 2003 effective dates should be recognized as deferred premium rather than amounts due from agents or policyholders.

The examiners found another issue in the Accounts Receivable Aging Report during the testing of individual policies. The report included an amount received from a policyholder as an initial payment for a policy with a 2003 effective date. The amount was included in the report as a negative balance at year-end. This makes it appear that the policy was never billed understating the asset.

A large portion of the receivable balance related to policies with 2004 effective dates, which should not be recorded at all in the 2003 annual statement, so the account balance was substantially overstated. The examination declined to make an adjustment to this line item because an exact calculation of the appropriate balance would require an expenditure of time beyond the resources of the examination because an electronic version was not available. However, it is recommended that the company take immediate actions to remedy the deficiencies in its computer-generated premium reporting system or find a new software provider. It is also recommended that the company report annual statement premium balances based on the effective date and not the billing date of policies and policy installments.

Premiums Deferred and Not Yet Due

\$192,910

This asset is intended to represent modal premium installments (such as monthly, quarterly, etc.) that are not yet due. In determining this balance, the company used a report generated from its software system titled "Unearned Premium Summary as of 12/31/2003." This summary report did not include detail for the amount reported as deferred on the annual statement. Through discussion with the company's software representative, it was determined that a detail report supporting this asset was not available. The examiners noted that the reported balance appeared to include installment amounts collected in advance of billing, which the company included as "Premiums Received in Advance," and unbilled deferred premium

installments for policies with 2004 effective dates. Due to the company not being able to provide a detailed report, the examiners were unable to confirm the amounts.

The examination declined to make an adjustment to this line item because an exact calculation of the appropriate balance would require an expenditure of time beyond the resources of the examination due to the fact that no detailed report was available to test and recalculate. Appropriate recommendations have been included in this section under the heading "Premiums, Agents' Balances in Course of Collection."

Investment Income Due and Accrued **\$20,672**

Interest due and accrued on the various invested assets of the company at December 31, 2003, consists of the following:

Cash Deposited at Interest	\$ 5,252
Bonds	<u>15,420</u>
Total	<u>\$20,672</u>

Electronic Data Processing Equipment **\$3,468**

The above balance consists of computer hardware and operating system software, net of depreciation as of December 31, 2003. A review of receipts and other documentation verified the balance. Non-operating system software was properly nonadmitted.

Reinsurance Contingent Commission Receivable **\$5,100**

The above asset represents the amount of reinsurance commissions that the company expected to receive as of December 31, 2003, based on the deferred premium on the liability business ceded under its contract with Grinnell Mutual Reinsurance Company. This amount is deferred and not contingent. The company does have a contingent commission agreement with Grinnell Mutual Reinsurance Company for liability business but due to losses incurred no amounts were earned. The company should have used a write-in for this balance as the receivable was not contingent.

In estimating reinsurance commissions, the company used unbilled premium on liability business from the report generated from its software system titled "Unearned Premium Summary as of 12/31/2003." The company then multiplied this amount, \$28,204, by an 18% commission rate. As discussed in this section under the heading "Premiums Deferred and Not

Yet Due,” the examiner was unable to determine the validity of the amount reported for deferred premium due to the company’s inability to provide sufficient detail. As noted, this amount may have included installment amounts collected in advance of billing, which the company included as “Premiums Received in Advance,” and unbilled deferred premium installments for policies with 2004 effective dates. In addition, the company receives 20% commission for liability business ceded to the reinsurer which would have understated the estimate of the receivable balance.

As with other premium-related items, the examination declined to make an adjustment to this line item because an exact calculation of the appropriate balance would require an expenditure of time beyond the resources of the examination. Appropriate recommendations have been included in this section under the heading “Premiums, Agents’ Balances in Course of Collection.”

Furniture and Fixtures

\$0

This asset consists of \$2,387 of office equipment owned by the company at December 31, 2003. In accordance with annual statement requirements, this amount has been deducted as an asset not admitted.

LIABILITIES AND SURPLUS

Net Unpaid Losses

\$140,000

This liability represents losses incurred on or prior to December 31, 2003, that remained unpaid as of that date. The examiners reviewed the reasonableness of this liability by totaling actual loss payments made subsequent to December 31, 2003, with incurred dates in 2003 and prior years. To the actual paid loss amount was added an estimated amount for 2003 and prior losses remaining unpaid at the examination date. The examiners' development of unpaid losses is compared with the amount estimated by the company in the following schedule.

	Company Estimate	Examiners' Development	Difference
Incurred but unpaid losses	\$707,999	\$648,234	\$59,765
Less: Reinsurance recoverable on unpaid losses	<u>568,000</u>	<u>567,219</u>	<u>781</u>
Net Unpaid Losses	<u>\$140,000</u>	<u>\$ 81,015</u>	<u>\$58,984</u>

The examiner's actual development of unpaid losses indicated a \$58,984 favorable development as compared to the company's estimate. However, open claims still exist and the possibility for adverse development still remains, therefore no adjustment will be reflected for the positive development.

The examiners' review of claim files included open claims, paid claims, claims closed without payment, and all claims which were denied during the examination period. The review indicated that claims are investigated and evaluated properly and that payments are made promptly and in accordance with policy provisions upon the submission of a proper proof of loss. In addition, the review of claims handling procedures and files revealed the following:

1. A proper loss register is maintained.
2. Claim files contained sufficient investigatory data and documentation to verify settlement payments or reserve estimates.
3. Proofs of loss were properly signed.

Unpaid Loss Adjustment Expenses

\$1,744

This liability represents the company's estimate of amounts necessary to settle losses which were incurred prior to December 31, 2003, but which remained unpaid as of year-end. The

methodology used by the company in establishing this liability was determined to inadequately estimate the company's loss adjustment expense.

The examination used a paid loss adjustment expense to paid loss methodology to determine the expenses incurred by the company related to the settlement of losses for the past five years. The examiners weighted the more recent year's data to reflect current trends. Using this methodology, the estimated unpaid loss adjustment expenses were \$11,655. The current difference was not adjusted due to the redundancy of unpaid loss reserves. However, it is recommended that the company adopt an actuarial method, such as the paid to paid methodology, in order to determine a more adequate loss adjustment expense reserve.

Commissions Payable

\$57,976

This liability is intended to represent the sum of commissions payable to agents for premiums collected on policies and commissions payable on deferred premiums with 2003 effective dates.

In determining the balance for commissions payable to agents for premiums collected on policies, the company used a report generated from its software system titled "Outstanding Commissions Payable for – 12/30/03." This report included amounts for commissions due for all premiums billed at year-end. The company billed 60 days in advance; therefore the report included commissions due for premiums billed for policies with effective dates in 2004, which should not be reported as an expense or liability until the effective date. The report also included commissions due for deferred premiums for policies with 2003 effective dates that were billed but not necessarily received.

In determining the balance for commissions payable on deferred premiums with 2003 effective dates, the company used a report generated from its software system titled "Unearned Premium Summary as of 12/31/2003." In reporting this portion of commissions payable, the company multiplied the deferred premium from the report mentioned above by the 14% commission rate. As discussed in this section under the heading "Premiums Deferred and Not Yet Due," the examiner was unable to determine the validity of the amount reported for deferred premium due to the company's inability to provide sufficient detail. As noted, this amount may

have included installment amounts collected in advance of billing, which the company included as "Premiums Received in Advance," and unbilled deferred premium installments for policies with 2004 effective dates.

It appeared to examiners that a large portion of the reported balance related to policies with 2004 effective dates, which should not be recorded at all in the 2003 annual statement, so the account balance was substantially overstated. The examination declined to make an adjustment to this line item because an exact calculation of the appropriate balance would require an expenditure of time beyond the resources of the examination. Appropriate recommendations have been included in this section under the heading "Premiums, Agents' Balances in Course of Collection."

Contingent commissions are annually calculated based on the loss ratio of an agency's book of business with the company. The review of commissions payable noted the company did not include a liability for contingent commissions at year-end. During 2004, the company paid agents \$17,154 in contingent commissions for 2003 activity. Examiners verified the contingent commissions paid to company worksheets. Given the uncertainty and possible overstatement of other premium-related accounts, the examination declined to make an adjustment to this line item. However, it is recommended that the company accrue contingent commissions due its agencies at year-end in accordance with the Town Mutual Annual Statement Instructions.

Fire Department Dues Payable	\$1,095
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This liability represents the fire department dues payable at December 31, 2003.

The examiners reviewed the company's fire department dues calculation and found this liability to be correctly calculated. The actual amount paid was verified to the cash disbursement records. Subsequent cash disbursements verified the amount of this liability.

Federal Income Taxes Payable	\$44,000
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This liability represents the balance payable at year-end for federal income taxes incurred prior to December 31, 2003.

The examiners reviewed the company's 2003 tax return and verified amounts paid to cash disbursement records to verify the accuracy of this liability.

Unearned Premiums

\$818,013

This liability is intended to represent premiums on policies in force at year-end that have not been earned. In determining this balance, the company used two reports generated from its software system titled "Unearned Premium Summary as of 12/31/2003" and "Unearned Premium Detail by Policy as of 12/31/2003."

The "Unearned Premium Summary as of 12/31/2003" was used by the company to determine the portion of unearned premium that was deferred. As discussed in this section under the heading "Premiums Deferred and Not Yet Due," the examiner was unable to determine the validity of the amount reported for deferred premium due to the company's inability to provide detail. As noted, this amount may have included installment amounts collected in advance of billing, which the company included as "Premiums Received in Advance," and unbilled deferred premium installments for policies with 2004 effective dates.

The "Unearned Premium Detail by Policy as of 12/31/2003" was used by the company to determine the portion of unearned premium that was not deferred. This report included unearned premiums for policies with 2004 effective dates that had been billed where no unearned premium reserve should have been recognized.

The company summed the totals for both reports and reduced the total by the amount of liability business ceded to the reinsurer.

It appeared to examiners that a large portion of the reported balance related to policies with 2004 effective dates, which should not be recorded at all in the 2003 annual statement, so the account balance was substantially overstated. The examination declined to make an adjustment to this line item because an exact calculation of the appropriate balance would require an expenditure of time beyond the resources of the examination. An appropriate recommendation has been included in this section under the heading "Premiums, Agents' Balances in Course of Collection."

This reserve was established using a daily pro rata methodology. This methodology was tested for accuracy and was determined to be functioning properly.

Reinsurance Payable

\$76,315

This liability is intended to represent amounts due to the company's reinsurer at December 31, 2003, relating to transactions which occurred on or prior to that date. This amount represents the sum of reinsurance payable on December 2003 premium and reinsurance payable on deferred premium.

The examination determined the accrual for reinsurance payable on December 2003 was fairly stated. The examiner was able to verify this amount in the company's January 2004 cash disbursement report and the reinsurance payable statement. However, it was noted that the company was being double billed for facultative reinsurance on one policy for approximately six months. It is recommended the company reconcile its reinsurance payable statement to ensure amounts agree with company balances.

In estimating deferred reinsurance payable the company used unbilled premium on liability business from the report generated from its software system titled "Unearned Premium Summary as of 12/31/2003." As discussed in this section under the heading "Premiums Deferred and Not Yet Due," the examiner was unable to determine the validity of the amount reported for deferred premium due to the company's inability to provide detail. As noted, this amount may have included installment amounts collected in advance of billing, which the company included as "Premiums Received in Advance," and unbilled deferred premium installments for policies with 2004 effective dates.

The examination declined to make an adjustment to this line item because an exact calculation of the appropriate balance would require an expenditure of time beyond the resources of the examination. Appropriate recommendations have been included in this section under the heading "Premiums, Agents' Balances in Course of Collection."

Amounts Withheld for the Account of Others **\$3,761**

This liability represents employee payroll deductions in the possession of the company at December 31, 2003. Supporting records and subsequent cash disbursements verified this item.

Accounts Payable **\$7,000**

A review of the company's documentation noted the reported amount was an estimated accrual for an employee pension plan. Supporting records and subsequent cash disbursements verified pension accrual as fairly stated. However, the company did not estimate an accrual for general expenses incurred prior to December 31, 2003. A search for unrecorded liabilities was performed and the examination found several invoices totaling \$1,561 for general expenses incurred in 2003 but paid in 2004. It is recommended that expense-related liabilities for unpaid obligations, including general expenses, be included in the annual statement in accordance with the Town Mutual Annual Statement Instructions. An adjustment was not made to this account due to immateriality.

Accrued Salaries and Wages **\$1,300**

This liability represents the balance payable at year-end for salaries and wages expense incurred prior to December 31, 2003.

The examiners reviewed the company's 2004 payroll records and verified amounts paid to cash disbursement records to verify the accuracy of this liability.

Premiums Received in Advance **\$62,659**

This liability is intended to represent total premiums received prior to year-end for policies with effective dates after December 31, 2003. The amount reported was the same amount as reported for this account at year-end 2002; the account appears to have not been adjusted during 2003. To determine this balance, the company used a report generated from its software system for 2003 it was titled "Premium Paid for Business After 12/31/2003." This report included: 1) amounts for all premiums received in advance at year-end for policies with 2004 effective dates totaling \$38,417 and 2) deferred installments paid in 2003 that were not due until

2004 for policies with 2003 effective dates totaling \$18,001. When deferred installments are paid in advance the company should reduce deferred premium.

The correct balance for this account appears to be \$38,417. Due to the uncertainties in the other premium reports, the examiner chose not to adjust this balance. Appropriate recommendations have been included in this section under the heading "Premiums, Agents' Balances in Course of Collection."

V. CONCLUSION

As of December 31, 2003, the company reported assets of \$1,975,281, liabilities of \$1,213,863, and Policyholders' Surplus of \$761,418. There were no reclassifications or adjustments to surplus made by this examination. However, adjustments would have been made to each of the following accounts if the amount of the adjustment could have been quantified in a timely manner: premiums, agents' balances in course of collection, premiums deferred and not yet due, reinsurance contingent commission receivable, commissions payable, unearned premiums, reinsurance payable, and premiums received in advance.

The company's surplus has remained relatively unchanged over the past four years. However, operating results have fluctuated significantly as the company reported underwriting losses in three of the last four years, due to several fires, heavy storm-related losses and associated loss adjusting expenses. Despite underwriting losses in 2000 – 2002, the company was able to post a positive net income in two of the last four years.

In the four years since the prior exam, gross premiums written and net premium written have increased by 4% and 14%, respectively. During the same period, policies in force decreased by 12%. Rate increases have offset losses in policy count and have contributed to the increases in written premium noted above.

The current exam resulted in 16 new recommendations and 1 suggestion which are summarized in the following "Summary of Comments and Recommendations" section of this report.

VI. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 17 - Corporate Records—It is recommended that the company document the number of policyholders present at each annual meeting so that it may be determined that a quorum was present and that the company is in compliance with s. 181.0722, Wis. Stat.
2. Page 17 - Corporate Records—It is recommended that directors with a potential conflict of interest properly abstain from voting on matters affecting their interest and that the minutes clearly indicate their abstention, pursuant to ss. 612.18 and 611.60 (2), Wis. Stat.
3. Page 17 - Corporate Records—It is recommended that all investment purchases and sales be discussed during meetings of the board of directors and that the minutes indicate that such discussions have taken place and whether the transactions were approved or disapproved.
4. Page 18 - Corporate Records—It is recommended the company obtain and retain a copy of all their agencies current E&O coverage to provide assurance that the agencies have adequate coverage.
5. Page 18 - Conflict of Interest—It is recommended that the board of directors clarify their conflict of interest statement to better define circumstances that would be considered conflicts. It is further recommended that the directors note all potential conflicts of interest on their statements, per directive of the Commissioner of Insurance.
6. Page 18 - Business Plan—It is recommended that the company submit a comprehensive business plan to the Commissioner of Insurance within 90 days of the adoption of this report. It is further recommended that the company review and update the plan on an annual basis.
7. Page 19 - Underwriting—It is suggested the company continue to re-inspect property to ensure that all business is insured to value.
8. Page 20 - Underwriting—It is recommended that the company either: 1) report all policies that may exceed the maximum per risk coverage to its reinsurer and allow the reinsurer to inspect the property and evaluate whether facultative reinsurance is necessary or 2) develop and consistently apply its own procedures to evaluate risks.
9. Page 20 - Claims Adjusting—It is recommended that the adjusting committee establish formal guidelines to adjust or review all losses over a certain dollar limit, meet regularly to review adjusting decisions, keep minutes of such meetings, and report regularly to the full board.
10. Page 20 - Claims Adjusting—It is recommended that the company establish an amount above which claims shall be approved by more than one employee of the company, officer, director, or agent pursuant to s. Ins 13.05 (4) (e), Wis. Adm. Code.
11. Page 23 - Investment Rule Compliance—It is recommended company report the correct type designation for all securities pursuant to the Town Mutual Annual Statement Instructions.

12. Page 26 - Premiums, Agents' Balances in Course of Collection—It is recommended that the company take immediate actions to remedy the deficiencies in its computer-generated premium reporting system or find a new software provider.
13. Page 26 - Premiums, Agents' Balances in Course of Collection—It is also recommended that the company report annual statement premium balances based on the effective date and not the billing date of policies and policy installments.
14. Page 30 - Unpaid Loss Adjustment Expenses—It is recommended that the company adopt an actuarial method, such as the paid to paid methodology, in order to determine a more adequate loss adjustment expense reserve.
15. Page 31 - Commissions Payable—It is recommended that the company accrue contingent commissions due its agencies at year-end in accordance with the Town Mutual Annual Statement Instructions.
16. Page 33 - Reinsurance Payable—It is recommended the company reconcile its reinsurance payable statement to ensure amounts agree with company balances.
17. Page 34 - Accounts Payable—It is recommended that expense-related liabilities for unpaid obligations, including general expenses, be included in the annual statement in accordance with the Town Mutual Annual Statement Instructions.

VII. ACKNOWLEDGMENT

The courteous cooperation extended to the examiners by the company's personnel is hereby acknowledged.

In addition to the undersigned, Karl Albert of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

Respectfully submitted,

Rebecca Easland
Examiner-in-Charge